

***United States Court of Appeals
for the Second Circuit***

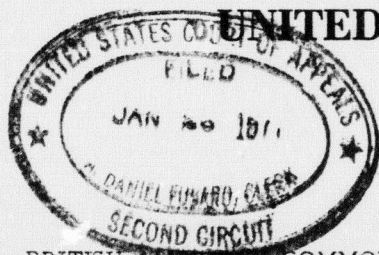


**APPELLANT'S
BRIEF**

77-6010/11

ORIGINAL
WITH PROOF
OF SERVICE

To be argued by
CHARLES J. HECHT
(20 minutes)



UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

B.P. 15

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs-Appellants,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS, INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs-Appellants,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLANTS

BRITISH AMERICAN COMMODITY OPTIONS CORP. AND LLOYD, CARR & CO.

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(6033B)

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PRELIMINARY STATEMENT

This brief is submitted on behalf of the plaintiffs, British American Commodity Options Corp. ("British American") and Lloyd, Carr & Co. ("Lloyd, Carr") with respect to appeals by all parties from the Memorandum and Order of the District Court for the Southern District of New York dated December 21, 1976, which preliminarily enjoined the defendants Commodity Futures Trading Commission (hereinafter sometimes referred to as the "CFTC") from implementing and enforcing Section 32.6, which was to become effective on December 27, 1976, of certain rules and regulations (the "regulations") promulgated by the defendants as published in the Federal Register on November 24, 1976 (276).¹ In addition, Judge Knapp granted the defendants' motion for summary judgment with respect to the validity of all the other sections of the regulations (526).

The jurisdiction of the Court, which was not contested, was premised on 5 U.S.C. §701 et seq., 7 U.S.C. §3, 28 U.S.C. §1331, 28 U.S.C. §1337, 28 U.S.C. §2201 and §2202.

On December 30, 1976, British American and Lloyd, Carr moved for a stay pending appeal (528), which motion was consolidated with the motion for reconsideration filed by the defendants on January 10, 1977 (554). On January 12, 1977

1. Numbers in parentheses refer to page number of Joint Appendix.

Judge Knapp denied all motions and clarified the order enjoining the defendants as to Section 32.6 of the regulations.² All parties filed their Notice of Appeal on January 13, 1977. On January 13, 1977, British American and Lloyd, Carr and the plaintiffs in 76 Civ. 2250 (D.C.D.C. 1976), which case was consolidated sua sponte by Judge Knapp in his Memorandum and Order, also filed motions for a stay and/or injunction relating to that portion of the regulations as to which Judge Knapp granted the defendants summary judgment (632, 638). After oral argument on January 18, 1977 this Court denied plaintiffs' motion but ordered an expedited briefing schedule and argument on February 10, 1977.

Throughout this litigation the defendants have contended that the plaintiffs herein are averse to regulation and wish to operate in an atmosphere of laissez faire. With the exception of one plaintiff, British American, which is in a unique situation hereinafter described in more detail, substantially all London commodity options dealers were registered as commodity trading advisors pursuant to 7 U.S.C. §6n and subject to all the pertinent rules and regulations of the CFTC which include, among other provisions, an extremely broad anti-fraud statute and investigatory powers in the staff of the CFTC.³

2. (619, 621, 622).

Furthermore, the record clearly indicates that it has always been the position of British American and Lloyd, Carr that it is in the best interests of both the investing public and the reputable members of this industry that the agency adopt reasonable regulations which are rationally related to the operation of this particular industry.

Plaintiffs perforce object, however, to regulations which Judge Knapp found, and one of the defendants has conceded, were promulgated under a statute without any standards (513), which are

- (a) manifestly punitive, arbitrary, capricious and unreasonable, the effect, and, it is submitted, the purpose of which is to force existing dealers immediately out of the industry they have pioneered because the defendants have indiscriminately and without factual basis labeled members of the London commodity options industry as "crooks" "bunco artists" and "hot check artists" and believe that only the largest companies should be permitted into this industry (44);
- (b) are detrimental to the investing public in that they will inflate premium costs through increased costs of doing business which do not benefit the public and eliminate meaningful competition;
- (c) clearly discriminate against London commodity

-
3. Registration as a commodity trading advisor ("CTA") by such companies was requested by the defendants under an interpretive release of the Office of General Counsel in October 1975. Plaintiff Lloyd, Carr is registered as a CTA. Plaintiff British American filed its CTA application in March 1976 and is still awaiting approval. The broad anti-fraud provisions contained in the Commodity Exchange Act are described in detail in Commodity Futures Trading Commission v. J.S. Love & Associates Options, Ltd., CCH Fed.Comm.Fut.L.Rep. ¶20,198 (S.D.N.Y. 1976).

options and retail dealers therein in favor of futures contracts, which are far more risky and leveraged to the investor, and the purveyors thereof in direct violation of 7 U.S.C. §19;

- (d) are inconsistent with each other; and
- (e) bear no rational relationship to the operations of the industry to be regulated.

No amount of rhetoric by the defendants can obfuscate plaintiffs' basic position or the unlawful nature of the defendants' actions under 5 U.S.C. §706(2)(A) et seq.

PRINCIPAL ISSUES PRESENTED

1. Does Section 32.6 (the segregation provisions) of the regulations violate 5 U.S.C. §706(2)(A), (B), (C) or (E)?

The District Court answered in the affirmative.

2. Do the other provisions of the regulations violate 5 U.S.C. §706(2)(A), (B), (C), (D) or (E)?

The District Court answered in the negative.

PRINCIPAL STATUTES

1. 5 U.S.C. § 553(d):

"The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except--

- (1) a substantive rule which grants or recognizes an exemption or relieves a restriction;
- (2) interpretative rules and statements of policy; or

- (3) as otherwise provided by the agency for good cause found and published with the rule."

2. 5 U.S.C. §706 in pertinent part provides:

"To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall--

- (1) compel agency action unlawfully withheld or unreasonably delayed; and
- (2) hold unlawful and set aside agency action, findings, and conclusions of law found to be--
 - (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
 - (B) contrary to constitutional right, power, privilege, or immunity;
 - (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory rights;
 - (D) without observance of procedure required by law;
 - (E) unsupported by substantial evidence in a case subject to sections 556 or 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or . . .

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule or prejudicial error." (emphasis added)

3. 7 U.S.C. §6c(b):

" (b) No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this chapter, but not specifically set forth

in section 2 of this title, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets."

4. 7 U.S.C. §19 in pertinent part provides:

"The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this chapter, as well as the policies and purposes of this chapter, in issuing any order or adopting any Commission rule or regulation,"

STATEMENT OF RELEVANT FACTS

To assist the Court in analyzing these proposed regulations (276), set forth below is a brief description of the actual method of operations of the plaintiffs herein and the regulatory background.

DESCRIPTION OF THE MECHANICS OF THE OPERATION OF THE TWO NAMED PLAINTIFFS HEREIN (461-468, 492)

1. General Marketing. The plaintiffs utilize the following techniques to obtain new customers:

- (a) direct mail;
- (b) telephone solicitation, including the use of what are commonly called lists;
- (c) newspaper advertising;
- (d) TV advertising; and
- (e) referrals from existing clients.

In the case of plaintiff British American, it is estimated that more than 30% of its existing customers are referrals from existing clients. As to plaintiff Lloyd, Carr, which has been in operation for a far shorter period of time, less than 10% of its customers are now derived from referrals.

2. Customer Orders. Upon receipt of a customer's indication to purchase a commodity option, the company furnishes to that customer what is commonly called an "open order notice." The plaintiff Lloyd, Carr calls this document a "confirmation and invoice." That document sets forth the following data:

- (a) order;
- (b) type of option;
- (c) commission;
- (d) market on which executed;
- (e) contract size of the underlying futures contract;
- (f) delivery month;
- (g) number of options ordered; and
- (h) price per option.⁴

4. If the customer's funds are not received by the dealer the customer is under no legal obligation to purchase
(cont. on next page)

British American's open order notice is to the same effect.⁵

It is important to note that the price per option set forth in the open order notice is guaranteed by the plaintiffs for five business days to their customers and, thus, even if they are charged a higher premium by the grantor of the option, they are required to make up the difference out of their own pocket. The open order notice is sent out immediately after the customer furnishes the order. In the normal course of business the customer's order is not executed until his funds are received by the plaintiffs.

Once the customer's funds are received by the dealer, the customer is then sent an execution confirmation slip, or in the case of Lloyd, Carr, what is termed a contract original.⁶

Prior to the regulations, the information reflecting the actual execution of the order on the ICCH and LME was identical to the information furnished on the open order

(cont. from previous page)

the option. In terms of the strike price, purchases are usually made at the current strike price for the option at the time the order is executed on the International Commodity Clearing House ("ICCH") or London Metals Exchange ("LME").

5. Under the new rules, option dealers, unlike purveyors of futures contracts, are required, prior to accepting any order, to furnish the customer a written bold-faced legend as to the negative aspects of investing in London commodity options. The injury resulting from complying with these requirements is evidenced by the monthly income statements of British American for the months of November and December 1976 (553).
6. A copy of the open order notice and execution of confirmation slips is set forth at page 490 of the Appendix.

notice with the following additions:

- (a) the date the option is purchased;
- (b) the confirmation date of the option contract;
- (c) the strike price per option; and
- (d) the reference number.⁷

The reference number exactly matches the reference number on the original option contract purchased by Lloyd, Carr's London clearing agent, Wilson, Smithett & Cope, Ltd., as well as the books of the ICCH and LME (490). Prior to computerizing its back office operations, British American also utilized a similar reference system number. But, because of the limitations in the existing software program it has been unable to put such reference numbers on the customers' execution confirmation slip. British American maintains a separate journal for recording these reference numbers for its customers. Both of these companies realized that this type of record-keeping procedure was required to protect their customers' interests in the event of their financial inability to assist the customer in the ultimate close-out of the transaction. This was done at substantial expense and without any guidance from the defendants.⁸

7. Under the regulations option dealers are required to disclose their gross commissions and fees and certain other data on the execution confirmation slip.
8. The defendants were advised by the undersigned of this record-keeping technique, a system which insures that the customer can exercise his option in the event of financial insolvency of the dealer, in writing on March 10, 1976 (66).

MECHANICS OF THE PURCHASE OF THE OPTION BY THE
PLAINTIFFS FOR THE ACCOUNT OF THEIR CUSTOMERS

- (a) Members of the ICCH or LME furnish quotations for options, both put and call, at varying expiration dates on a current basis on Reuters (two times a day) or via telephone (as many times as the dealer elects).
- (b) Upon receipt of the customer's funds which are time stamped, the plaintiffs transmit this order by telex or telephone to their clearing members who executes the order.
- (c) When the order is executed the strike price is fixed as well as the premium to be charged by the grantor of the option. The plaintiffs are advised by telex of the terms of the execution of the customer's order and promptly transmit to their clearing member in London the necessary funds to pay the premium due to the grantor of the option.
- (d) Both the grantor of the option and the plaintiffs' clearing broker record the trade, including all of the necessary data, on their books.
- (e) The ICCH also registers the option and, where appropriate, the underlying futures contract on its books setting forth the date and time of execution, the expiration date, the commodity and the name of the broker on either side of the

transaction.

- (f) The details of the transaction are then transmitted to the plaintiffs.
- (g) After execution of the option order the writer of the option is required at the close of each business day to mark-to-market the current market value of all open transactions on its books, which would include any options transacted by it through plaintiffs and subsequently executed by their clearing broker. In addition, the writer of the option is required to furnish 100% of the premium to the ICCH which in turn escrows the premium until the option is exercised or abandoned. Accordingly, existing mechanisms provide double protection for the option premium. To assure additional financial integrity under the ICCH by-laws, in addition to the guarantees of the writer and taker of the option, the ICCH guarantees fulfillment of each futures option.⁹

Transactions on the LME are similar except that there is no centralized procedure for registering and processing the option. The LME has approximately 33 individual members all of whom are substantial companies who are required to post a bond in excess of \$1,000,000.¹⁰

9. For the convenience of the Court, copies of the ICCH "green book" will be made available at oral argument.

CLOSE OUT OF THE OPTION

- (a) When the customer elects to sell or declare (also called "exercise") his option, he so advises the plaintiffs, who in turn telephone or telex into the clearing member the order.¹¹
- (b) The clearing member so advises the ICCH and the customer's option is converted to a long futures contract at the same strike price.¹²
- (c) Accordingly, on the books of the ICCH, both sides of the original option transaction are now reflected as a long and short futures contract contra to each other.
- (d) The clearing member then goes into the market and sells a futures contract short on the ICCH for the benefit of a customer to close out against the long futures contract held for the benefit of that customer.

10. In the past 125 years neither the ICCH or LME have ever defaulted in the execution of an option transacted through them. See Affidavit of James Carr sworn to December 4, 1976 (496). The CFTC has not denied this. Plaintiffs' customers are the beneficial owners of the option and, thus, are the true beneficiaries of the integrity of the exercise of the option afforded by the London clearing houses.

11. The beneficial owner of a London commodity option, unlike the beneficial owner of a futures contract, can put in a stop loss order as well as an open market order. For purposes of the description, we will assume an open market order.

12. See description of haircuts with respect to net capital in Exhibit "C" to the Amended Complaint (330-332).

- (e) The net proceeds, which is the customer's equity, is then transmitted to the plaintiffs, who in turn immediately transmit the funds to the customer.¹³

At no time during this transaction do the plaintiffs maintain customer's funds for more than 24 hours.¹⁴

PRIOR REGULATORY BACKGROUND

Pursuant to 7 U.S.C. §6c(b) the defendants originally proposed rules relating to commodity options transactions in the Federal Register on February 20, 1976 (55), which in pertinent part provide as follows:

- (a) the Commission has proposed not to impose segregation requirements on premiums as to commodity options dealers (57);
- (b) disclosure by dealers would be required by way of substantial filings with the CFTC,

-
13. To the extent that this equity exceeds the customer's cost of the option, he has a profit. To the extent that the equity is less than the customer's original cost, he has a loss. Where the strike price on declaration is less than the strike price set forth in the customer's purchase, the option is abandoned as the customer realizes no equity.
14. Accordingly, segregation is totally inapplicable to dealers who live up to their commitments and actually purchase the options for their customers. As to those dealers who are "crooks", to paraphrase Vice Chairman Rainbolt (44), the segregation requirement would be meaningful since these parties have taken it upon themselves to guarantee the performance of the commodity operation in a direct conflict of interest situation vis-a-vis their customers. It also encourages dealers to "churn" customers' accounts so that the segregated funds can be used to remain in business. This may also violate various criminal statutes and consumer anti-fraud laws.

along the lines of reports by securities broker-dealers with the SEC and not by way of a punitive and discriminatory disclosure statement to potential or actual customers (63, 64);

- (c) minimum financial requirements, with one notable exception, which were rationally related to the actual operations of the members of the industry (64, 65);
- (d) registration not required as an FCM since that is prohibited by Reg. 1.19 (62); and
- (e) completely different record-keeping requirements (65).

The defendants held one day of public hearings in the beginning of March 1976, in which counsel for British American participated (724).¹⁵

Thereafter, on October 8, 1976 defendants published in the Federal Register proposed regulations relating to commodity options transactions which were a complete turnabout from the prior proposals of the defendants. In the interim the defendants formed an Advisory Committee.¹⁶

The regulations published on October 8, 1976 contained

15. Plaintiffs' counsel was requested to and did furnish written comments setting forth the position of British American and proposed suggestions (66).

16. The Advisory Committee totalled 17 persons, not one of whom had any prior experience or affiliation with persons dealing directly or indirectly in London commodity options (80). Furthermore, this Committee never consulted any member of this industry or person affiliated therewith nor did they request any information concerning the industry. It is self-evident that certain members of this committee represented interests which could best be served by eliminating all members of the existing industry so that their companies or clients would be in a position to have an oligopoly (cont. on next page)

a provision for written submissions by interested parties. Although these proposed regulations contained an effective date of November 20, 1976, the defendants indicated that there would be public hearings with respect to these regulations in December, 1976 (491).¹⁷ In accordance with the Federal Register notice, British American, by its counsel, on November 4, 1976, submitted written comments and requested either public hearings or an administrative hearing in view of the blatant, punitive nature of such regulations which had no relationship to the entire operations of the existing members of this industry (20). It was only when plaintiffs' counsel insisted on November 11, 1976 upon being told when the public hearings would be scheduled that it was ascertained for the first time by an interested party that the defendants never intended to hold any hearings or give any consideration to the comments of interested parties and that their scheme was to have the regulations become effective on November 20, 1976 (33).

As a result, on November 15, 1976 British American and Lloyd, Carr served a Complaint (1). Immediately thereafter the defendants withdrew the regulations published on October

(cont. from previous page)
with respect to the retailing of London commodity options to the investing public in the United States. See Sierra Club v. Morton, 405 U.S. 727, 745, 746, 31 L.Ed.2d 636, 649 (dissent).

17. This information was furnished to plaintiffs' counsel as a courtesy by one of the large commodity trading houses.

8, 1976 and stated that they would consider certain of the written comments submitted by the interested parties in issuing new regulations. On November 24, 1976, "revised" regulations were published in the Federal Register, substantially all of which went into effect on December 9, 1976 (276). For all practical purposes, with one material exception, they were identical to the regulations published on October 8, 1976.¹⁸

ARGUMENT

I. A FEDERAL DISTRICT COURT HAS JURISDICTION TO ENJOIN A FEDERAL REGULATORY AGENCY FROM IMPLEMENTING AND/OR ENFORCING REGULATIONS PROMULGATED BY SUCH AGENCY AND IN CONNECTION THEREWITH TO GRANT DECLARATORY RELIEF

The defendants' contemptuous position is that since under 7 U.S.C. §6c(b) of the Commodity Exchange Act of 1974, as amended (the "Act"), they could ban all commodity options, the courts have no authority to review regulations relating to commodity options (389).¹⁹ This position is refuted by: (i) the express language of 7 U.S.C. §6(b) and

18. Disclosure of gross mark-up and fees should be made in the execution confirmation slip, and not the open order notice. Since plaintiffs guarantee the total cost to their customers but do not execute the customer's order until the funds are received, they run the risk of any changes in the premium charged by the grantor of the option between the customer's indication of interest and the execution of the order. Accordingly, the gross mark-up cannot be ascertained until after the order is executed. The proposal to require disclosure of gross mark-up in the open order notice in the October 8, 1976 regulations was ludicrous.

the underlying legislative history; (ii) well established Supreme Court precedents; and (iii) common sense and the concept of due process of law.

The statute explicitly states that the defendants must adopt rules or regulations and that such rules and regulations "may be made only after notice and opportunity for a hearing."²⁰ Accordingly, Congress specifically intended the provisions for judicial review set forth in 5 U.S.C. §§702 through 706. Both the statute and the underlying legislative history demonstrate that Congress, by giving the defendants one year to formulate regulations with the right to obtain an extension, clearly intended that the CFTC give thorough and thoughtful consideration to regulations relating to commodity options. S.Rep. 93-1194 93d Cong., 2d Sess. (1974).²¹

The Supreme Court has clearly stated that parties adversely affected by agency action are entitled to pre-enforcement judicial review under 5 U.S.C. §702. Abbott

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19. If Congress arbitrarily sought to eliminate the commodity options business, it would violate due process under the Fifth Amendment which a fortiori applies to the defendants as well as the provisions of 5 U.S.C. §706(2)(A), (B) and (C).
 20. Reference is made to the subsequent discussion of 5 U.S.C. §706(2)(D) and the defendants' failure to comply with both the letter and spirit of 5 U.S.C. §553 (d).
 21. The Advisory Committee Report (172-232) found that there were economic justifications to trading in commodity options and set forth that at the present time, the only bona fide clearing mechanisms were provided by the ICCH and LME, in London, England.

Laboratories v. Gardner, 387 U.S. 136, 87 S.Ct. 1507, 18 L.Ed.2d 681 (1967); Toilet Goods Association v. Gardner, 387 U.S. 158, 87 S.Ct. 1520, 18 L.Ed.2d (1967); and Gardner v. Toilet Goods Association, 387 U.S. 167, 87 S.Ct. 1526, 18 L.Ed.2d 704 (1967). These three cases are commonly referred to as the Abbott Laboratories trilogy, which was recently reaffirmed by the Supreme Court in Dunlop v. Bachowski, 421 U.S. 560, 95 S.Ct. 1851, 44 L.Ed.2d 377 (1975).

The Abbott Laboratories trilogy sets forth two tests to determine ripeness for judicial review: (i) fitness of the issues for review and (ii) potential hardship to the plaintiffs if the court refuses to hear the case. This is a matter of common sense and it is self-evident that the instant case meets these tests.²² See Continental Airlines, Inc. v. C.A.B., 522 F.2d 107 (D.C. Cir. 1975) and Danielson v. Local 275, Laborers Union, 479 F.2d 1033 (2d Cir. 1973). Also see Gordon & Co. v. Board of Governors of Federal Reserve System, 317 F.Supp. 1045 (D.C. Mass. 1045) and State of Florida v. Weinberger, 492 F.2d 488 (5th Cir. 1974). It

22. As hereinafter explained, Section 32.6 (the so-called "double segregation" rule) is so punitive that as a practical matter all existing companies specializing in commodity options would be forced out of business. Section 32.3 (the "registration" provisions) as presently worded, and subsequently interpreted by the defendants, may force over 14 companies to cease operations and deny over 1,000 persons the right to earn a livelihood. The other major provisions, minimum financial requirements and disclosure, as presently worded, will eventually put the plaintiffs out of business although their impact is not as immediate or dramatic.

is axiomatic that the power to regulate is not the power to destroy and limitation is not the equivalent of confiscation. Stone v. Farmers Loan & Trust Company, 116 U.S. 307, 6 S.Ct. 334, 29 L.Ed.2d 636 (1885). The CFTC is not above the law, as they arrogantly contend.

In granting plaintiffs' request for a preliminary injunction as to "double segregation", the District Court properly rejected the defendants' position (500-527). The defendants' disdain for a jurisprudential system of law was illustrated by its press releases and public pronouncements threatening that if Judge Knapp did not grant their motion for reconsideration, they would consider banning all options (537-538).²³ Under Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402, 91 S.Ct. 814, 28 L.Ed.2d 136 (1971), which is the leading case on the standards of judicial review of administrative action, the District Court could have declared Section 32.6 and any other section null and void and remanded this back to the agency for further consideration rather than issue a preliminary injunction. National Resources Defense Council, Inc. v. Securities and Exchange Commission, 389 F.Supp. 689 (D.C.D.C. 1974).

23. After Judge Knapp denied defendants' motion for reconsideration (615-625), the defendants held a press conference on January 17, 1977, where John Rainbolt, one of the defendants herein, stated that if the segregation issue was not resolved in the CFTC's favor, they would consider banning all options and that the defendants are even considering abolishing all commodity option transactions while the case is on appeal before this Court.

As the Supreme Court enunciated in Citizens to Preserve Overton Park v. Volpe (supra), the existence of judicial review is only the starting point. The next step is to analyze the standards of judicial review, as prescribed by 5 U.S.C. §706(2)(A) et seq., to the particular regulations before the Court.

SECTION 32.6 ("DOUBLE SEGREGATION")

- II. THE DISTRICT COURT PROPERLY HELD THAT SECTION 32.6 OF THE REGULATIONS VIOLATED 5 U.S.C. §706(2)(A) AND, THUS, HAD THE AUTHORITY UNDER THE CIRCUMSTANCES TO GRANT A PRELIMINARY INJUNCTION
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Section 32.6 of the regulations, which was to become effective on December 27, 1976, requires that each dealer must segregate in a special account 90% of all customer funds received until the customer's option is either exercised or abandoned. Section 32.6, which is now commonly referred to as "double segregation", was first announced by the defendants on October 8, 1976.²⁴ The defendants purported rationale to justify this regulation is the conclusory statement that it is required to protect the customers.

The simple unrefuted fact is that the "double segre-

24. For all practical purposes, all prior proceedings by the defendants so far as they relate to Section 32.6 are meaningless since they had previously taken the position that segregation was not required for commodity options transactions by U.S. dealers (57).

gation" requirements bear absolutely no relationship to the protection of customers or the actual operations of the members of this industry.

In the first place, it does not guarantee performance on the customer's unrealized profits above the premium paid for the transaction. In the second place, as the expiration date of the option nears, the value of the premium declines; it is axiomatic that the longer the term of the option, the higher the cost to the customer. See letter of Shearson, Hayden Stone & Co. by Max Liebler, dated November 1, 1976 (417-420).

The disastrous effect on the operations of British American and Lloyd, Carr of "double segregation"²⁵ can be seen from the following analysis based on the November 1976 income statement of British American prepared by Katz, Zuckerman & Co. (and furnished to the District Court) (553):

25. "Double segregation" is a misnomer as the negative impact on the cash flow of a company is close to 400%.

Total cost of option to customer	\$2,250.00
Premium transmitted immediately to London as payment to the writer of the option	<u>1,550.00</u>
Gross commission of British American before expenses	700.00
Commissions payable to executing brokers and sales employee(s)	<u>236.00</u>
Gross profit on transaction prior to allocation of indirect expenses:	464.00
Indirect expenses:	
Telephone	\$126.92
Rent	6.16
Indirect sales expenses	32.47
Back office salaries and computer expenses	20.11
Legal and accounting	35.10
Officer salaries	2.28
Research department	11.20
Misc.	<u>14.10</u>
Total indirect expenses ²⁶	<u>248.34</u>
Pre-tax profit	215.66
Provision for taxes	<u>133.00</u>
Next after-tax profit on transaction	<u>82.66</u>

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26. Commodity options is a relatively new business. To enter the marketplace, companies are required to spend substantial funds. Up until the publication of these regulations, the so-called wire houses elected not to enter this area, with one exception, Shearson, Hayden Stone & Co., which marketed this product primarily to existing customers. As the investment community
(cont. on next page)

If Section 32.6 was in effect, out of each \$2,250 received by British American from a customer, it would be required to send \$1,550 to London and then, in addition, place \$2,025 in a segregated account until the option is either exercised or abandoned by the customer. In clarifying the original order, Judge Knapp specifically held that the requirement of segregating an additional 90% of the customer's total purchase price was unreasonable and fully supported his decision to preliminarily enjoin the defendants from implementing and enforcing Section 32.6 (615-625).

In terms of cash flow, this would require that for each \$700 in gross cash inflow, British American would have a gross cash outflow, before taxes, of \$2,734. On a percentage basis, this is a negative cash outflow of approximately 390%. Not even General Motors could survive under these circumstances. Since the average time a commodity option is held is in excess of six months, this would require British American to raise a minimum of an additional \$12,000,000 in capital until the options start liquidating. British American is concededly the largest company in the United States exclusively specializing in London commodity

(cont. from previous page)
becomes more aware of the advantages of commodity options in comparison to futures contracts sold on margin, the indirect expenses, such as telephone, will decline as a percentage of gross profit on the sales.

options.²⁷ Accordingly, the defendants' position that Judge Knapp erred in not holding an evidentiary hearing on the issue of irreparable harm as to the segregation requirements is untenable. The defendants are the very party who represented to the District Court that there were no issues of fact (350-355).

Having raised no issues of fact, the defendants are in no position to question the discretion of the lower court in granting a preliminary injunction, and it cannot be said that the lower court abused its discretion. Doran v. Salem Inn, Inc., 422 U.S. 922, 95 S.Ct. 2561, 45 L.Ed.2d 648 (1975); Brown v. Chote, 411 U.S. 452, 93 S.Ct. 1732, 36 L.Ed.2d 420 (1973). Having gambled and lost as to segregation, they cannot now reverse their position and request an evidentiary hearing when no prior request was made at the appropriate time. S.E.C. v. Frank, 388 F.2d 486, 493 at footnote 6 (2d Cir. 1968).

Furthermore, as heretofore shown, the customer's investment is, in effect, double guaranteed by the ICCH mechanism of escrowing the entire premium and, in addition, requiring the writer of the option to mark-to-market at the close of

27. At oral argument on December 10, 1976, defendants' counsel admitted that the practical effect of "double segregation" would be to put all existing dealers out of business and, perforce, only large diversified brokers such as Merrill Lynch or Conti Commodities would have the capital from their other operations to satisfy the CFTC (see page 104 of transcript).

business each day. Thus, in the above example, up to the point that the option is worth \$0 to \$1,550, there is \$1,550 to \$3,100 in direct proportion to the equity in the option behind that option of which \$1,550 is held in an escrow account with the ICCH. The record is undisputed that neither the ICCH or LME have ever defaulted in a commodity option transaction in the last 125 years (496-497). Thus, segregation adds nothing to existing customer "protections" and overlooks the major point that the customer is entitled to be protected for his entire equity (i.e., the premium plus, if applicable, profits).

It has always been the position of British American and Lloyd, Carr that from the customer's point of view, the two crucial factors under these circumstances, are the protection of all of the customer's equity, as distinguished from just 90% of his initial cost, and the preservation of his right to close out the option when he so elects. A problem could only arise if there is both an intervening bankruptcy of a retail commodity option dealer, and no method to promptly trace the customer's option to the ICCH or LME to effectuate a close-out. The defendants' sudden reliance on the fact that the guarantee mechanism does not run directly to the U.S. customer is ill-conceived since the U.S. customer, as the beneficial owner of the option is the true beneficiary of the guarantee mechanisms and ignores the reality of the basic nature of an exchange or clearing organization. The

segregation requirements are clearly punitive, arbitrary, capricious, and unreasonable and are totally unrelated to protecting the customer or his equity in an option.

Although in this type of litigation, the suggestion of better solutions is not part of the judicial function, the solution for any potential problems resulting from the financial insolvency of a dealer is obvious: appropriate record-keeping procedures and information furnished to the customer so that a trustee in bankruptcy or other appropriate party, as the case may be, knowing the reference number of a particular option held by the customer, which is also reflected on other records of the retail dealer, clearing member firm and the ICCH, is in a position to immediately effectuate the close-out of the option when the customer so elects.²⁸ The defendants were aware of this solution as early as March 1976 (6-19, 724-776).

At the present time, and even prior to the adoption of these regulations, Lloyd, Carr furnishes directly to its customers the option number reflected on the books of its clearing broker and the ICCH (493, 499). Since British American is now computerized, they maintain a separate journal reflecting this information (550). These measures were adopted without any guidance from the defendants. The

28. If the clearing broker's name is furnished to the customer upon request, he can close out his position through a dealer of his choice.

public interest should be concerned with suitable protections for all of the customers' equity and not the satisfaction of selfish interests of a few large brokerage houses who want a monopoly based on the prior efforts and capital of parties who are being forced out of business.

In this connection, it should be noted that the underlying basis of the defendants' justification of segregation can only be that the guarantees of the ICCH members and their requirement to segregate all option premiums plus mark-to-market the equity in all transactions at the close of business every day, and of the ICCH itself, as well as the member guarantees of the LME plus a substantial bond are worthless. The explanatory notes to the regulations are devoid of any references to these procedures of the ICCH and LME. The defendants have stated that they have devoted many months and much effort to this area so they were obviously aware of these basic facts and that there has never been a default on either the ICCH or LME with respect to options transacted through those exchanges in over 125 years of operation.^{29, 30}

29. Query, as to the defendants' deliberate, and, I submit, bad faith, omission of any reference to the ICCH and LME guarantees in either the regulations or explanations thereto? Query, as to the recent potato scandal and the statement at page 7 in the explanatory preface to the regulations, that the defendants' "experience in the field of futures contracts has been salutary in comparison to the options area" (282)?

In addition, members of the LME are required to post substantial bonds to further guarantee performance while the ICCH itself guarantees the execution of the option even if one of its members should happen to go into bankruptcy or be unable to perform. In addition, the ICCH is extremely well automated and efficient in processing options and along with the LME, is the only facility which marks-to-market each option at the close of business on each day.³¹ See letter from George Lamborn of Shearson, Hayden Stone & Co. to William T. Bagley dated April 5, 1976, included in Part 3 of defendant's Appendix. Furthermore, in the event that a member ever defaulted in the future, it would for all practical purposes destroy commodity option trading in London. This would be pennywise and pound-foolish and the defendants' hypothetical assumption that this may happen, as the purported but unstated rationale justifying segregation, is clearly not justified by past experience or common sense.

An additional protective measure to appropriate record-keeping is to have a simple, straightforward minimum net

30. The defendants' refusal to hold any evidentiary proceedings or public hearings as was clearly contemplated by 7 U.S.C. §6c(b) with respect to the need for "double segregation" now becomes obvious, as the uncontradicted evidence would have shown that there was no factual basis to justify the admittedly punitive segregation provisions promulgated in these rules and regulations. No wonder the defendants never held the public hearings.

31. See ICCH "green book" which will be made available to the Court at oral argument.

capital requirement which insures the financial stability³² of the option dealer, who acts as an agent (741). The real issue is why are the defendants unwilling to properly discharge the regulatory functions which were given to them in the Commodity Exchange Act of 1974, as amended?

The defendants' segregation approach is so poorly conceived that it borders on the ridiculous. There are three alternative alternatives. The first is to sell naked options. In this way the dealer does not have to pay the premium to the writer of the option as he never actually purchases the option for the customer and, thus, he eliminates to a great extent the financial hardship of segregation. Of course, everyone knows that the writing of naked options (i.e., the Goldstein-Samuels situation) was the abuse which resulted in the 1974 amendments to the Commodity Exchange Act and the creation of the CFTC as an independent regulatory agency. To now permit and encourage the writing of naked options is clearly contrary to the public interest. It is also clearly a fraud and violates state criminal laws such as embezzlement and grand larceny. Furthermore, it encourages churning (i.e., the rapid turnover of the customers' options) which as to the investors in commodity options is clearly against their best interests. The second alternative is to im-

32. For the reasons hereinafter set forth, the minimum financial requirements proposed by defendants are discriminatory and totally inapplicable to the plaintiffs' method of operations.

mediately go out of business.

The third alternative suggested by the defendants is to have the dealer obtain suitable financing to comply, which the District Court found not to be persuasive (524). Financing forces British American and Lloyd, Carr, as well as other dealers similarly situated, into a non-competitive position and is economically impracticable since the finance charges would exceed their profits. Finance charges, estimated at 2% above prime, or 8-1/4% to 8-1/2% would substantially exceed the return on government obligations.³³ The interest differential paid by option dealers for this item alone would approximate their net profit.

The only entities that will profit are the large securities broker-dealers who are very willing to finance the segregation. Everyone else loses. The investing public will have these increased costs passed on to them, which the defendants admit but state is irrelevant, thus diminishing their chances to profit and the amount of any profits. What happened to the concept of protecting the investor? The plaintiffs and other retail dealers will be required to

33. The defendants assume that financing will be available. However, even if one could obtain financing, who would want to? Under this regulatory framework, the business would be economically unfeasible and lenders would hardly be attracted to an industry which could not meet competition and is faced with a regulatory bias, as evidenced by their "hot line" and adverse public relations campaign. Also since these are deemed customers' funds, they cannot be collateral for a loan to a dealer.

increase their mark-ups to cover such additional expenses in order to remain solvent. They will thus become non-competitive with the major wholesalers of options and purveyors of futures contracts and CBOE options in direct violation of 7 U.S.C. §19. Why should commodity option dealers be treated as a pariah?

In direct conflict with this "justification" is the defendants' position under the disclosure provisions that retail dealers must disclose their mark-ups because it is their belief that the mark-ups of certain dealers are too high. Who are the defendants trying to fool? The short and simple result will be that, by hook or by crook, the defendants will force the plaintiffs to cease operations.

In addition, at least as early as March 1976, the Commission was asked to consider the utilization of the Securities Investors Protection Committee and insurance and bonding and the suggestions were dismissed out of hand (735, 770-773). After attempting to rush these regulations through in the minimum period of time and using tactics to insure minimum participation, for the defendants now to take the position that the regulated parties have not come up with a viable alternative is unconscionable.

SECTION 32.3 ("REGISTRATION")

III. THE DISTRICT COURT ERRED IN NOT VOIDING
OR ENJOINING THE DEFENDANTS FROM IMPLE-
MENTING §32.3 OF THE REGULATIONS (THE
"REGISTRATION" PROVISIONS)³⁴

In the proceeding before Judge Knapp, British American and Lloyd, Carr contended that the registration provisions should be declared null and void and/or the defendants should be enjoined from implementing and enforcing these provisions because they directly contradicted Reg. 1.19 and/or did not provide the requisite standards or safeguards in violation of due process. Judge Knapp stated that it was his opinion that the proper function of the lower court in cases of this genre is to frame the issues for the Court of Appeals (615). Unfortunately, Judge Knapp never discussed the absence of due process standards and safeguards raised by British American and Lloyd, Carr in summarily ruling as to the validity of the registration provisions (500).³⁵

Prior to the publication of these regulations, the plaintiff Lloyd, Carr was registered as a commodity trading

34. Section 32.4, in theory, offers exemptive relief to parties with respect to all sections of Part 32, except 32.2, 32.8 and 32.9.

35. As to NASCOD's argument that the plaintiffs and others similarly situated should not be classified as futures commissions merchants ("FCMs"), it is the position of these plaintiffs that so long as the defendants promulgate proper rules which have some rational relationship to this industry and the protection of the general public, the particular designation of a registrant in and of itself is irrelevant.

advisor ("CTA") with the CFTC pursuant to 7 U.S.C. §6n. British American filed its application as a CTA in March, 1976. See Commodity Futures Trading Commission v. British American Commodity Options Corp., CCH Fed.Comm.Fut.L.Rep. ¶20.224 (S.D.N.Y. 1976). Under an opinion of the Office of General Counsel, London commodity option dealers were, until the promulgation of the instant regulations, required to be registered as CTAs. Now under §32.3, London commodity option dealers must register as FCMs and their employees, who are engaged in sales, must register as associated persons ("APs"). The regulation further provides that unless such companies and persons are registered on or before January 17, 1977, as distinguished from filing such applications before a set date, and whether or not they are already registered as CTAs, it shall be unlawful for them to continue to do business and, thus, they must cease all operations and their existing employees must seek other employment. Lloyd, Carr filed its application as an FCM on October 1, 1976 (702). The Commission advised this Court in its papers that Lloyd, Carr never filed such an application (648). This is just another attempt by the defendants to mislead the court, as shown by a copy of the time-stamped application of Lloyd, Carr filed with this Court (705). Immediately after Judge Knapp's decision, British American filed its registration applications as an FCM and AP applications for its sales employees.³⁶ As of the date

hereof, neither British American nor Lloyd, Carr are registered as FCMs, nor are any of their employees yet registered as associated persons.

Unlike 7 U.S.C. §6n, which governs registration of CTAs, 7 U.S.C. §§6f and 6k governing the registration of FCMs and APs respectively are devoid of any standards, safeguards, or criteria for accepting or rejecting applications for FCM or AP status. Additionally, the defendants were aware that even under 7 U.S.C. §6n, a federal court has already noted that the statutory language of the Act relating to the registration provisions as a CTA, may in some circumstances be violative of constitutional due process. See Commodity Futures Trading Commission v. British American Commodity Options Corp. (supra), at footnote 6 to Appendix at page 21,218. In this connection it is extremely important to

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36. British American never received any communication from the defendants relating to its FCM application other than hearing second-hand by way of defendants' press conference on January 17, 1977, at which Vice Chairman Rainbolt stated that the defendants had instituted administrative proceedings against certain companies, one being British American, to deny them registration and, as a result of the institution of these administrative proceedings, these subject companies must cease doing business. At the time of this press conference, no copy of the Complaint in this proceeding had been served on either British American or its counsel. Additionally, the defendants' Complaint included an order of consolidation on its own motion with a prior proceeding involving the registration of British American as a CTA, as to which the evidentiary hearing was concluded on December 15, 1976. This order was made without notice or the opportunity for hearing, and in direct violation of Rule 10.63 of its Rules of Practice.

note that under 7 U.S.C. §6n(2), registration as a CTA shall become effective 30 days after receipt of such application by the Commission or within such shorter period of time as the Commission may determine, while on the other hand, §§6f and 6k do not impose any such restraints on the defendants in the processing of applications. Thus, as shown by the Lloyd, Carr situation, the defendants by mere inaction are in a position to arbitrarily and capriciously deny or delay any company or person registration as an FCM or AP, as the case may be and, thus, force them to cease operations.³⁷

It is hornbook law that when an agency has licensing and similar powers, which directly affect the material rights of individuals (i.e., the right to earn a livelihood), and adopts regulations as to such powers it must set forth

37. At the January 17, 1977 press conference of defendants, which was reported in the Wall Street Journal, and the London Financial Times, and certain other publications, they stated that it was their position that all companies and individuals not yet registered under §32.3 must immediately cease doing business, notwithstanding the fact that they had filed their applications prior to January 17, 1977 and in many cases are registered as CTAs pursuant to the dictates of defendants. At this press conference the defendants also announced that any persons or companies which filed after December 27, 1976 would not have their applications processed and advised the Wall Street Journal, as set forth in an article published on January 18, 1977 that it would take up to six months to process applications. On January 18, 1977, this Court denied the application of British American and Lloyd, Carr to enjoin the regulations pending the hearing of this appeal but ordered the briefs and argument on an expedited basis.

some objective standards since it is intolerable to grant absolute and uncontrolled discretion which is abusive and in contravention of due process. Holmes v. New York City Housing Authority, 398 F.2d 262 (2d Cir. 1968); Hornsby v. Allen, 326 F.2d 605, 610 (5th Cir. 1964), cited with approval in Goldberg v. Kelly, 397 U.S. 254, 90 S.Ct. 1011, 25 L.Ed.2d 285 (1970). Also see Baker, Chaput v. Cammet, 406 F.Supp. 1134 (D.C.N.H. 1976); and Smith v. Ladner, 288 F.Supp. 66 (S.D. Miss. 1968).

The registration provisions as to both FCMs and APs come squarely within this rule. As to the individual employees of British American and Lloyd, Carr, as well as the employees of other affected companies, the problem is even more severe. There are two categories to consider: (i) persons already employed in the industry, and (ii) potential employees. Under 7 U.S.C. §6n there is no requirement for employees of a CTA, other than control or supervisory persons, to register with the defendants. However, §32.3(a) and (b) require that if such persons are not registered as associated persons on or before January 17, 1977, such persons may not be employed in a sales capacity with the company and any company that utilizes a person in sales who is not registered, is automatically deemed to be violating the law. (See footnote 23 [supra].) Since there are no standards in the statute, or in the regulations establishing any criteria applicable to the registration of such persons as APs, the defendants are in a position to arbi-

trarily deny any person registration as an AP. The prime example is the action of the defendants in refusing to process many AP applications without furnishing or even being required to furnish the reason for their failure favorably to process such applications. If the defendants press release in the Wall Street Journal cited above at footnote 37 is taken at face value, any person wishing to become an AP filing after December 27, 1976 will have to wait up to six months to make a living. This requires the Court to void §32.3 of the regulations.

The underlying rationale was stated by the Supreme Court over 90 years ago in Yick Wo v. Hopkins, 118 U.S. 356 (1886) in the following language:

"When we consider the nature and the theory of our institutions of government, the principles upon which they are supposed to rest, and review the history of their development, we are constrained to conclude that they do not mean to leave room for the play and action of purely personal and arbitrary power For, the very idea that one man may be compelled to hold his life, or the means of his living, or any material right essential to the enjoyment of life, at the mere will of another, seems to be intolerable in any country where freedom prevails" at p. 369-70.

The arrogance of the defendants is best illustrated by their statements on January 17, 1977, that they would not process any applications filed after December 27, 1976 except at their leisure. But, Judge Knapp's ruling was only made available on the evening of December 21, 1976 and it was

some time before this was disseminated to all members of the industry as well as their employees who are directly affected.³⁸

Accordingly, this Court should declare §32.3 null and void or in the alternative, enjoin the defendants from implementing and enforcing such provisions.

Section 32.3 poses a critical problem to the industry because, as presently worded, it will be almost impossible to hire new employees to either replace former employees or expand operations since the staff is in a position to process applications at its whim and, thus, the industry will be unable to attract new people. Certain commentators suggested that the appropriate procedure would be for the defendants to establish an objective test and that once a person passed that test, he would automatically become registered subject to the defendants bringing a denial proceeding as permitted under 7 U.S.C. §12(a) (22).

In the securities industry,³⁹ the Securities and Exchange Commission ("SEC") has set up a procedure with the National Association of Securities Dealers, Inc. ("NASD") pursuant to §15A of the Securities Exchange Act of 1934, as

38. Counsel for the CFTC advised this office orally that it was their position that this litigation was frivolous and that parties were not entitled to wait for Judge Knapp's ruling on December 21, 1976 to determine their registration status. This is untenable as Judge Knapp enjoined the defendants as to "double segregation." The irony is that Judge Knapp for some reason while noting that 7 U.S.C. §6c(b) contains no standards, failed to consider this in rendering his original decision as to Section 32.3, as it is clearly applicable where it goes directly to the right of someone to earn a livelihood without being deprived of their due process.

amended, whereby the NASD administers a test to registered representatives and once the registered representative passes the test, he automatically is permitted to engage in the retail sales of securities. NASD By-Laws II Schedule C. This procedure also contained a grandfather clause pursuant to which people who were performing the functions of a registered representative or a registered principal prior to the effective date automatically became registered as if they had passed the appropriate test. 7 U.S.C. §6p authorizes the defendants to administer tests and permits the CFTC to promulgate rules and regulations permitting a grandfather clause. If, in fact, the defendants were truly concerned with the public interest, such a procedure, as authorized and contemplated by the Act, would limit persons engaged in this industry to those who had demonstrated by objective criteria the requisite knowledge and integrity to properly deal with the public. Unfortunately, the defendants, in their haste to put the existing retail London commodity option dealers out of business and replace them with an oligopoly of the five or six largest securities dealers, have overlooked their own standards, the best interests of the general public and fundamental due process safeguards of the regulated parties.

39. See CFTC v. J.S. Love Associates Options, Ltd. (supra), and CFTC v. British American Commodity Options Corp. (supra), applying prior decisional law under the federal securities laws to the Commodity Exchange Act of 1974, as amended.

Their attitude is best evidenced by the fact that although §32.4 contains an exemption for hardship, this exemption only applies to Part 32 of the regulations. On the other hand, under Reg. 1.19, FCMs cannot underwrite issue or otherwise assume any financial responsibility for the fulfillment of any transaction which is of the character commonly known in the trade as an option. The defendants have deliberately refused to repeal, amend or clarify Reg. 1.19 to exclude persons engaged as agents in the purchase and sale of London commodity options. The defendants are well aware that they can always take the position that since the retail London commodity options dealers are responsible for transmitting customer funds to and from London they "otherwise assume financial responsibility" (21,22).. Accordingly, under §32.3 and Reg. 1.19, British American and Lloyd, Carr, as well as other dealers similarly situated, by registering as futures commission merchants to avoid the Scylla of being put out of business for violation of that section, run head on into the Charybdis of Reg. 1.19, which prohibits option dealing by futures commission merchants by the deliberate actions of the defendants.⁴⁰

In conclusion, the District Court erred in not voiding and/or enjoining the defendants from implementing §32.3 of

40. Reference is made to the ever-changing interpretations of the defendants as to the proper computation of minimum net capital (pages 86-88 of the transcript of December 10, 1976) (539-543, 607).

the regulations. It is submitted that this Court should declare such regulation null and void and direct that the matter be referred back to the agency in accordance with the principles enunciated in Citizens to Preserve Overton Park v. Volpe (supra).

AMENDMENTS TO REGULATION 1.17
OF THE GENERAL REGULATIONS
(MINIMUM FINANCIAL REQUIREMENTS)

IV. THE DISTRICT COURT ERRED IN NOT DECLARING
NULL AND VOID REG. 1.17 OF THE GENERAL
RULES INSOFAR AS THEY ARE APPLICABLE TO
DEALERS EXCLUSIVELY ENGAGED IN COMMODITY
OPTIONS

Reg. 1.17 requires that the dealer have minimum capital of the greater of (i) \$50,000, or (ii) the sum of the safety factors, as defined in Reg. 1.17, plus 5% of the applicant's aggregate indebtedness (hereinafter referred to as the "alternative minimum financial computation"). Once they become registered as FCMs both British American and Lloyd, Carr must be in compliance with this requirement at all times.

This requirement, with one crucial exception, is identical to the minimum financial requirements imposed upon companies who sell futures contracts and extend credit to their customers. Since the defendants concede that British American and Lloyd, Carr are agents who do not extend credit, it is clearly arbitrary, capricious and unreasonable in violation of 5 U.S.C. §706(2)(A) to require them to have a minimum capital of \$50,000 while persons who sell futures

contracts and extend credit are only required to have a minimum capital of \$10,000.

As previously framed, the minimum financial requirements applicable to British American and Lloyd, Carr are invalid under 5 U.S.C. §7062(B). 7 U.S.C. §19 provides:

"The Commission shall take into consideration the public interests to be protected by the anti-trust laws and endeavor to take the least anti-competitive means of achieving the objectives of this chapter . . . in issuing any order or adopting any Commission rules or regulation . . ." (emphasis supplied)

Judge Knapp specifically held that it was sufficient that the defendants considered the anti-competitive impact of various alternatives. It is respectfully submitted that the District Court misread the statute. "Regulations of Commodity Options" by David Buxbaum, N.Y.L.J., January 12, 1976, pages 1, column 1, and back page (680, 681). Additionally, this "reading" contradicts the underlying legislative history and the federal policy of encouraging competition.

The anti-trust provisions of the Act were not inserted by accident. When the statute was originally proposed and drafted by the House, it contained a provision which merely required the Commission to take into consideration the public interest to be protected by the anti-trust laws. The Department of Justice objected to this language and as a result of their efforts, the House version of the Act was amended to also require the CFTC to endeavor to take the least anti-competitive means. 1974 U.S. Code Cong. Adm. News, pages 5847 and 5863.

Similarly, even in the absence of a specific Congressional mandate to foster competition, federal courts have not hesitated to declare unlawful and set aside agency actions which do not take into effect the federal anti-trust laws. Pillai v. C.A.B., 485 F.2d 1018 (D.C. Cir. 1973); Overseas Media Corp. v. McNamara, 385 F.2d 308 (D.C. Cir. 1967); and Hecht v. Pro-Football, Inc., 444 F.2d 931 (D.C. Cir. 1971), cert. denied, 404 U.S. 1047, 92 S.Ct. 701, 30 L.Ed.2d 736.

The reason the defendants have ignored their own statute in promulgating these rules, especially as to required disclosures, is that British American and Lloyd, Carr and certain other companies similarly situated have, through their efforts and capital, made London commodity options a viable and popular investment vehicle in this country, thus taking away substantial business from purveyors of futures contracts, who are also regulated by the defendants, as well as securities broker-dealers who deal in CBOE options.

The undersigned respectfully submits that the creation of an "Advisory Committee" dominated by the defendants and persons who have a pecuniary interest in the industry most competitive with London commodity options was not an accident. See Justice Douglas' dissent in Sierra Club v. Morton (supra). At no time did this "Advisory Committee" ever consult any member of this industry. It is little wonder that the regulatory structure applicable to purveyors of futures contracts on margin was indiscriminately super-

imposed on options dealers.

This becomes acute when the alternate minimum financial requirement computation is relevant. Under Regs. 1.17(c), 2(xi), (e)(2)(xii) and (c)(4)(ii), Lloyd, Carr and British American are required to exclude all income for the next six to eighteen months while they are charged with all expenses. As to British American, this amounts to approximately \$225,000 per month or an aggregate of additional capital of \$1,350,000 to \$4,050,000 (553).

Furthermore, under Reg. 1.17(7), Lloyd, Carr and British American are required to take a 5% "haircut" on customers' equity and, thus, they are placed in a direct conflict of interest pattern with their customers. The better the customer does, the greater the charge to net capital. Thus the very success of its customers could force a company out of business.

During oral argument on December 10, 1976, defendants' counsel represented to the Court that the undersigned's interpretation of net capital was incorrect (at pages 86-88). Unfortunately Judge Knapp relied directly on this misrepresentation in granting defendants' motion for summary judgment on this segment of the regulations. Yet at that time, as the District Court was subsequently advised, the audit staff of the defendants, in processing FCM applications, was following the undersigned's interpretation in ruling upon whether applicants had the requisite capital to

qualify as an FCM (539-542). Thereupon the defendants allegedly "reversed" their interpretation of Reg. 1.17(7) in the only affidavit filed by them in this litigation (607-610). The result of these numerous changes in defendants' interpretation of "haircuts", which are directly related to representations made to the District Court, has been utter chaos in the industry. "Interpretations" vary depending on who is doing the audit, who is being audited and when the audit is being conducted. In effect, there are no uniform standards so that the regulated parties are not in a position to make the necessary computations to determine whether or not they are in compliance with Reg. 1.17.

The defendants' position that registration must be effected by January 17, 1977, which requires compliance with Reg. 1.17 presents an intolerable situation. Under such circumstances, at the very minimum the District Court should have preliminarily enjoined the defendants until they finally determine how they intend to compute the alternate minimal financial computations so that the Court is in a position to properly rule on this portion of the regulations. In any event, the District Court clearly erred in granting the defendants motion for summary judgment based upon the oral misrepresentations of counsel.

SECTION 32.5 (DISCLOSURE)

V. THE DISTRICT COURT ERRED IN NOT HOLDING
THAT SECTION 32.5 OF THE REGULATIONS
VIOLATED 5 U.S.C. §706(2)(A) AND (B)

Section 32.5 of the regulations sets forth the most severe disclosure requirements for any form of investment in the United States (312-316). British American and Lloyd, Carr have no quarrel with the concept of full and fair disclosure. However, they strenuously object to arbitrary disclosure requirements directed solely at this industry which places it at an obvious competitive disadvantage with purveyors of commodities futures contracts and CBOE stock options. In an analogous situation the Supreme Court held that a preliminary injunction should have issued. Doran v. Salem Inn, Inc. (supra). As shown by the income data furnished by British American for the months of November and December 1976, these disclosure requirements have already had a material and adverse impact on its business; gross option premium have declined from \$2,238,748 to slightly less than \$1,000,000, resulting in a 900% decrease in net income (553).

When commodity options are compared to commodity futures contracts sold on margin, the punitive nature of the disclosure requirements mandated for option dealers, when no such requirements are required of purveyors of futures contracts, is clear. A commodity option is a safer in-

vestment than a futures contract in three important aspects:

- (a) the customer cannot lose more than his initial investment as there are no margin calls as in the case of a futures contract purchased on margin;
- (b) an intervening adverse price fluctuation between the date of purchase and the declaration date cannot wipe out an investment in an option as in the case of a futures contract if a margin call is required; and
- (c) with respect to commodity options, stop-loss orders may be entered, while no such mechanism is available for futures contracts.

Yet notwithstanding the foregoing differences, one group is required to make extremely negative disclosures to its customers, many of which are clearly slanted and improper, while the other industry, which helped formulate these "regulations" is under no such limitation.

In both its papers and at oral argument, defendants' counsel took the position that the additional mandated costs of doing business resulting from the disclosure requirements will be passed on to the customer, while at the same time, attempting to justify these disclosure requirements on the arbitrary assumption that the mark-ups are too high. In short, there is absolutely no rhyme or reason to these disclosure requirements other than the destruction of all existing London commodity option dealers. The irony of the situation is that counsel to British American and Lloyd, Carr, during the oral argument on December 3, 1976, advised the court that these proposed disclosure requirements would

have a material and adverse impact on the business of his clients. However, the court's interpretation of irreparable harm was that for purposes of a preliminary injunction, you must show without a doubt that the requirement will immediately put the plaintiff out of business, which is obviously the case with "double segregation." It is respectfully submitted that the prior case law in this circuit clearly supports the plaintiffs' position. See Stark v. New York Stock Exchange, 466 F.2d 743 (2d Cir. 1972); Exxon Corporation, et. al v. City of New York, et. al, 480 F.2d 460 (2d Cir. 1973); Culf & Western Industries, Inc. v. The Great Atlantic and Pacific Tea Company, et. al, 476 F.2d 692 (2d Cir. 1973); Checker Motors Corporation v. Chrysler Corporation, 405 F.2d 319 (2d Cir. 1969); and Danielson v. Local 275, Laborers Union (supra).

VI. THE DISTRICT COURT ERRED IN NOT VOIDING
THE REGULATIONS FOR FAILURE TO COMPLY
WITH 5 U.S.C. §§553 AND 706(2)(D) AND
IN GRANTING SUMMARY JUDGMENT ON THIS
ISSUE TO THE DEFENDANTS

The regulations were published in the Federal Register on November 24, 1976. With the exception of the segregation requirements, which were scheduled to become effective on December 27, 1976, and registration, which became effective on January 17, 1977, all of the provisions of the regulations were scheduled and did become effective on December 9, 1976 (277). Although the registration provisions required that parties must be registered, as distinguished from filing, by January 17, 1977, the defendants suggested that applications be filed 30 days before the deadline (283). In addition, under Section 32.3 of the regulations and Reg. 1.17(a), as amended, compliance with the minimum financial requirements prior to the filing of an application as an FCM is a prerequisite to acceptance as an FCM registrant (305).⁴¹

In granting summary judgment for the defendants, with respect to 5 U.S.C. §706(2)(D), which concededly incorporates the provisions of 5 U.S.C. §553 in cases of this type, the Court found that the statements set forth in the Federal

41. On January 17, 1977, the defendants stated for the first time that all persons who had not filed after registration as an FCM or AP by December 27, 1976 must cease operations and stated that it could take up to six months to process these applications (684, 685, Wall Street Journal, January 18, 1977).

Register Notice (323, 324) satisfied the "good cause found" exception to the requirement that a substantive rule must be published 30 days before its effective date.⁴²

The purpose of 5 U.S.C. §553 is to allow the general public, and in particular the parties to be regulated, to meaningfully participate in the rule-making process, and to enable the agency to properly educate itself prior to establishing rules which have a substantial impact on those to be regulated. Texaco, Inc. v. Federal Power Commission, 312 F.2d 740 (3d Cir. 1969); NLRB v. Wyman Gordon Co., 394 U.S. 759, 89 S.Ct. 1436, 22 L.Ed.2d 709 (1969). Congress in adopting 7 U.S.C. §6c(b) specifically stated that the defendants may promulgate rules and regulations "only after notice and opportunity for a hearing." The imposition of this condition upon the defendants was deliberate. 1974 U.S. Cong. Adm. News at page 5850.

The procedures and tactics adopted by the defendants throughout this regulatory process are in direct defiance of

42. In footnote 32, the District Court stated that since the regulations contained in the November 24, 1976 notice relieved prior restrictions set forth in the October 8, 1976 notice, the 30 day requirement is inapplicable under §553(d)(1). In fact, a reading of these two publications shows that there were only three changes: (i) the timing of disclosure of mark-ups (see footnote 18); (ii) the reduction of segregation from 100% to 90%; and (iii) a different time schedule for the effective dates of Section 32.6 and Reg. 1.19 which was harmful to the regulated parties because if there is no segregation, the minimum capital rule requires a 5% "haircut" on aggregate customers' equity.

the clear and unambiguous Congressional mandate. As heretofore shown, anything prior to October 8, 1976 is window dressing since the October 8, 1976 Federal Register Notice represented a complete reversal of anything published by the Commission prior thereto. The defendants then caused to be disseminated a document indicating public hearings in December 1976 (491) when they never intended to hold public hearings or consider any comments from interested parties (32-34). In short, while the industry was preparing for a hearing in December, at 12:01 a.m. on November 20, 1976 they would have found themselves out of business.

It was only after the original Complaint was filed on November 15, 1976 that the defendants withdrew their October 8, 1976 regulations and paid lip service to the public's comments and immediately republished the regulations on November 24, 1976, substantially all of which were to and did become effective on December 9, 1976. This is obviously not the type of public participation which Congress intended in giving the defendants, by statute, a minimum of one year to promulgate rules and regulations.

The cases are uniform in holding that to come under the 30 day notice exception, the agency must preface the regulations with a "finding and brief statement of the reasons therefor." Kelly v. United States Department of Interior, 389 F.Supp. 1095 (E.D.Cal. 1972); Texaco, Inc. v. Federal Power Commission (supra); City of New York v. Diamond, 379

Carried to its logical conclusion, Judge Knapp's ruling on this issue would render 7 U.S.C. §553 and 5 U.S.C. §706(2)(D) meaningless, since it would permit a governmental agency to furnish conclusory statements to justify emergency effectiveness of a rule, which statements may be false or misleading or have no factual relationship to the subject rules, without the right of the aggrieved parties to question the truth and validity of such conclusory statements. In this case, summary judgment on this issue is a travesty of justice because the conclusory statements utilized by the defendants and relied upon by the District Court are either unrelated to these new regulations or directly contradicted by the evidentiary material supplied by British American and Lloyd, Carr.

The defendants have raised the flag that this is an emergency because the public must be protected from the fraudulent conduct of the members of this industry.⁴⁴ However, as the defendants concede, their anti-fraud rules have been applicable to the members of this industry for over 18 months and they have vigorously "enforced" these rules. Sections 32.8 and 32.9 of the regulations were

43. It should be noted that defendants also failed to meet the requirements of 5 U.S.C. §553(c) in that they failed with respect to substantially all of the regulations to incorporate "a concise general statement of their basis and purpose." P.A.M. News Corp. v. Hardin, 440 F.2d 255 (D.C. Cir. 1971) (transcript of December 10, 1976 at page 61).

inserted for mere technical reasons and will have no substantive effect on fraudulent activity prior to, or after the effective date (301). Also see CFTC v. J.S. Love & Associates Options, Ltd. (supra). The second reason put forth by the defendants and relied upon by the District Court is that

"there has been ample notice and public participation in this rulemaking proceeding and affected persons have adequate notice and opportunity to comment . . ." (emphasis added)

The unrefuted fact is that all of the public comments prior to the publication of proposed regulations on October 8, 1976 were meaningless since the prior proposals of the defendants were completely different from this rulemaking proceeding. Furthermore, it is clear that the defendants' conduct evinced the desire to rush these regulations through with a minimum of participation by the parties who are to be directly subject to such rules.

The third conclusion stated by the defendants is that the regulated parties had adequate opportunity through prior notices to take the necessary steps to be in full compliance with the proposed rules. This is not supported by the record. In essence the defendants are saying that the regulated parties should have ignored their statements that there would be public hearings prior to adoption of final

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44. Self-serving press releases are not a substitute for evidentiary facts.

regulations and planned accordingly. It is unconscionable to permit a party, even if it is a governmental agency, to take advantage of its own misleading conduct.

VII. THE DISTRICT COURT ERRED (A) IN FAILING TO PRELIMINARILY ENJOIN THE IMPLEMENTATION OF §§1.17, 32.3 AND 32.5, AND (B) IN GRANTING, IN PART, DEFENDANTS SUMMARY JUDGMENT

The Memorandum and Order make clear that with respect to Reg. 1.17 (minimum financial requirements) and Section 32.5 (disclosure), the District Court's disposition was based primarily upon the argument of counsel for the defendants in open court. The Court failed to give consideration to the complete lack of constitutional standards and safeguards of Section 32.3 (registration). On the question of irreparable harm the Court overlooked the severe criminal penalties provided by 7 U.S.C. §13(c) (imprisonment for up to one year and a fine of up to \$100,000) for any violation of the Act.

A. PLAINTIFFS' RIGHT TO A PRELIMINARY INJUNCTION

In support of its position, British American and Lloyd, Carr presented substantial evidence of irreparable injury as well as facts sufficient to raise serious questions going to the merits. The defendants submitted not a single affidavit. British American and Lloyd, Carr accordingly met the test for preliminary injunctive relief established in Doran v. Salem Inn, Inc. (supra), as well as the test for such relief long accepted in this Circuit as recently enunciated in Sonesta Int'l Hotels Corp. v. Wellington Associates, 483 F.2d 247 (2d Cir. 1973) where the court stated that a pre-

liminary injunction will issue:

"[O]nly upon a clear showing of either (1) probable success on the merits and possible irreparable injury, or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the party requesting the preliminary relief." at page 250 (emphasis in the original)

In the instant case the parties to be registered are already subject to a broad anti-fraud statute and all of the registered parties are registered CTAs, except British American, which filed as a CTA in March 1976. In enjoining segregation, as distinguished from his granting of defendants' summary judgment on the other provisions of the regulations, the District Court made appropriate findings of fact and conclusions of law as required by Rule 52(a) of the Federal Rules of Civil Procedure.

The defendants' contention that the District Court erred in not holding an evidentiary hearing with respect to the irreparable harm to be suffered by the plaintiffs herein on the segregation provisions is not well-founded. In the Second Circuit it is clear that in this type of situation there is no need for an evidentiary hearing. Herbert Rosenthal Jewelry Corp. v. Grossbardt, 428 F.2d 551 (2d Cir. 1970).⁴⁵ Since the irreparable damage here is so obvious, there is precedent in this circuit for granting an injunction

45. Unlike S.E.C. v. Frank (supra), there are no substantial and sharply disputed issues such as fraud, intent or knowledge.

even where the party's chances of success are de minimus. Semmes Motors, Inc. v. Ford Motor Co., 429 F.2d 1197 (2d Cir. 1970), which was cited with approval in Atchison T. & S.F.R. v. Wichita Board of Trade, 412 U.S. 800, 93 S.Ct. 2367, 37 L.Ed.2d 350 (1973). Also see Jacobson & Co. v. Armstrong Cork Co., 416 F. Supp. 564 (S.D.N.Y. 1976). Since British American and Lloyd, Carr have clearly raised substantial issues as to the provisions of the regulations other than segregation, the District Court should have entered a preliminary injunction with respect to those provisions. Under the unusual circumstances of this case, it was an abuse of discretion for the District Court not to consider the issue of irreparable harm with respect to the provisions of the regulations other than segregation.

B. SUMMARY JUDGMENT WAS IMPROPERLY GRANTED

The District Court apparently felt it had but two choices: (i) to grant a preliminary injunction or (ii) to grant the defendants' motion for summary judgment. In this it erred.

Assuming arguendo that the court properly denied the plaintiffs' prayer for injunctive relief with respect to the regulations other than §32.6 (segregation), this does not inexorably lead, as the court seemed to conclude, to finding that the plaintiffs had no right to a hearing on the merits.

As stated above, all of the factual data before the

court was presented by British American and Lloyd, Carr and, accordingly, if summary judgment were proper it should have been granted to the plaintiffs.

However, the facts presented by plaintiffs were introduced solely in support of their application for preliminary injunctive relief and it was, accordingly, improper for the Court to preclude plaintiffs' right to a hearing on the merits. As the Court said in Progress Development Corporation v. Mitchell, 286 F.2d 232 (7th Cir. 1961):

"No plaintiff is required to prove his case on the merits at a preliminary hearing. The argument, after such a hearing on an equity issue, that no genuine issue of fact is disclosed is fallacious. If summary judgment is appropriate on this ground after a preliminary hearing only, then the preliminary hearing becomes in fact a trial on the merits and its whole purpose is lost." at page 233

In granting the defendants' motion for summary judgment in part, the District Court denied plaintiffs' request for a preliminary injunction pending a hearing on the merits of the request for declaratory relief. In contrast to its ruling on segregation, the District Court did not set forth its findings of fact and conclusions of law as specifically required by Rule 52(a) of the Federal Rules of Civil Procedure. The Supreme Court in Gibbs v. Buck, 307 U.S. 66, 59 S.Ct. 725, 83 L.Ed 112 (1939) summarized the controlling principle as follows:

"It is of the highest importance to a proper review of the action of a court in granting or refusing a preliminary injunction that there

should be fair compliance with Rule 52a of the
Rules of Civil Procedure."

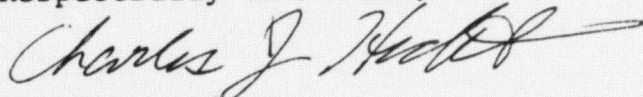
Also see United States v. Crescent Amusement Co., 323 U.S.
173, 65 S.Ct. 254, 89 L.Ed. 160 (1944).

CONCLUSION

On the basis of the foregoing, British American and Lloyd, Carr respectfully request that:

1. The Court affirm in all respects that portion of the order dated January 3, 1977 which granted a preliminary injunction with respect to the implementation and enforcement of Section 32.6 of the regulations, and
2. The Court reverse in all respects that portion of said order which granted defendants' motion for summary judgment.

Respectfully submitted,



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Of Counsel:

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By David Greene, Esq.
Martin Kaplan, Esq.

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

ROBERT LA GRASSA, being duly sworn,
deposes and says that deponent is not a party to the action,
is over 18 years of age and resides at 62-20 60th Rd.
MASPETH, NYC.

That on the 26th day of JANUARY, 1977,
deponent personally served the within BRIEF OF PLAINTIFFS-
APPELLANTS, BRITISH AMERICAN COMMODITY OPTIONS CORP. AND LLOYD, CARR & CO.
upon the attorneys designated below who represent the
indicated parties in this action and at the addresses below
stated which are those that have been designated by said
attorneys for that purpose.

By leaving true copies of same with a duly
authorized person at their designated office.

By depositing 2 true copies of same enclosed
in a postpaid properly addressed wrapper, in the post office
or official depository under the exclusive care and custody
of the United States post office department within the State
of New York.

Names of attorneys served, together with the names
of the clients represented and the attorneys' designated
addresses.

HOWARD SCHNEIDER, ESQ.
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2033 K Street, N. W.
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LEONARD GOLDSTEIN, ESQ.
Goldstein, Ahalt & Bennett
Counsel for other Plaintiffs-Appellants
4321 Hartwick Rd.
College Park, Maryland

Sworn to before me this

26th day of JANUARY, 1977.

Robert La Grassa
Michael DeSantis

MICHAEL DESANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Bronx County
Commission Expires March 30, 1978